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SUBJECT: ARMENIA'S INFLATIONARY START TO 2005

1. Armenia's Consumer Price Index (CPI) rose 5.4 percent in the month of January, exceeding in one month the government's target for the entire year. Press reports cite a senior National Statistics Service official who claims that the rise in the CPI is due to an 8.4 percent rise in the prices of foodstuffs, which compose over 70 percent of the consumer basket. While Armenia's high winter inflation is typically offset by seasonal deflation during the summer, this January's inflation rate is twice that of January 2004 (2.5 percent), itself the beginning of an inflationary year.

2. Armenia's consumption basket is based heavily on imported basic food products. Inflation in Armenia is therefore sensitive to the world prices of food, especially grains, differences in transit costs, which vary seasonally, and currency fluctuations. Armenia's geopolitical isolation makes it especially vulnerable to rising costs or restrictions on the few trade routes in and out of the country. The Central Bank blamed surges in the price of wheat for last year's inflation of 7 percent, well above the government's 3 percent target.

3. Inflation was high in 2004 and in the first month of 2005 despite a dramatic appreciation (20 percent) in the Armenian national currency, the Dram, against the U.S. dollar and Euro. The Dram's appreciation should have eased inflationary pressure by making imports cheaper in the national currency. Comment: If the current inflationary trends continue but the Dram fails to appreciate against the dollar, inflation in 2005 could well exceed the high levels of 2003 and 2004.

EVANS